No. 93-520

Supreme Court, U.S.
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IN THE

Supreme Court of the United States

October Term, 1993

GEOFFREY, INC.,
Petitioner,

vs.

SOUTH CAROLINA DEPARTMENT OF REVENUE AND TAXATION,
Respondent.

ON PETITION FOR WRIT OF CERTIORARI TO THE SUPREME COURT OF SOUTH CAROLINA

BRIEF FOR THE OHIO CHAMBER OF COMMERCE AS *AMICUS CURIAE* IN SUPPORT OF THE PETITIONER

TERRENCE G. PERRIS
Counsel of Record
WILLIAM H. CONNER
SQUIRE, SANDERS & DEMPSEY
4900 Society Center
127 Public Square
Cleveland, Ohio 44114
(216) 479-8647

TED B. CLEVENGER
SQUIRE, SANDERS & DEMPSEY
1300 Huntington Center
41 South High Street
Columbus, Ohio 43215
(614) 365-2700

Counsel for Amicus Curiae
Ohio Chamber of Commerce

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This brief in support of the Petitioner is submitted with the written consent of counsel to the parties, copies of which accompany this brief and are being filed with the Clerk of the Court.

INTEREST OF *AMICUS CURIAE*

The Ohio Chamber of Commerce ("OCC") is a statewide organization with over 5,000 members that represents the interests of a diverse cross-section of business, industry, and private enterprise in Ohio. The OCC has a vital interest in the equitable and efficient administration of state tax laws and policies that affect the business community. Of particular importance to the membership of the OCC is the increasingly complex and costly multi-state tax compliance burden being placed on the business community as each individual State attempts to reach beyond its own borders in search of increased tax revenue.

The decision of the Supreme Court of South Carolina in this case will have a profound effect on a substantial number of Ohio businesses that have licensed others to use their intangible property outside Ohio. Heretofore, if an Ohio business had no physical presence in a State, it was widely believed in the business community, based on decisions of this Court, that such State lacked authority under the Constitution to exercise its taxing jurisdiction over the Ohio business. Because the decision of the Supreme Court of South Carolina is a significant departure from established legal principles, the OCC has a strong interest in the issues presented in the Petition for a Writ of Certiorari.

SUMMARY OF ARGUMENT

The Supreme Court of South Carolina affirmed the trial court's holding that the Petitioner, as licensor of various trademarks used by a related corporation in South Carolina, was subject to the State's income tax and business license fees, despite the fact that the Petitioner has no employees or offices in South Carolina and owns or leases no tangible property situsued there. In so holding, the South Carolina court rejected Petitioner's contention that it lacked a nexus with South Carolina sufficient to satisfy either the Commerce Clause or the Due Process requirements of the Constitution. Both of Petitioner's arguments regarding the errors of the decision below merit review by the Court.

The South Carolina court erroneously concluded that physical presence is not a prerequisite to establishing substantial nexus for Commerce Clause purposes. That holding is inconsistent with the contrary consensus that has long prevailed between taxpayers and the States. In departing from that consensus, the South Carolina court's decision exposes owners of intellectual and other intangible property both to open-ended income tax liability for past years and to the heavy burden of complying with the reporting requirements of more than 6,000 taxing jurisdictions. This will seriously restrict the interstate commerce in such intangible property. If the bright-line physical presence test is not to be applied with respect to income taxation, that decision should be made only through the legislative process where appropriate accommodations can be made to deal with prior-year obligations and to prevent a disruption of this increasingly important element of interstate commerce. In addition, the South Carolina court's expansive standard for determining the existence of the minimum contacts required for Due Process nexus is so terribly overbroad that it extends the concept of minimum contacts beyond recognition and leads to irrational results.

ARGUMENT

1. Substantial Nexus for Commerce Clause Purposes Requires a Physical Presence That Does Not Exist in This Case.

This Court has never sanctioned the imposition of a state income tax on an entity organized under the laws of another State that has no physical presence in the taxing State through the presence of employees or agents or the ownership or lease of tangible personal property. It is thus a gross mischaracterization of the law for the Supreme Court of South Carolina to say that, for Commerce Clause purposes: "It is well settled that the taxpayer need not have a tangible, physical presence in a state for income to be taxable there." Pet. App. A at 9a.[1]

The South Carolina court understandably cites no decision of this Court as authority for its conclusion. Neither does it cite decisions of any other courts. Apparently, the only basis for its conclusion is language in the Court's opinion last term in *Quill Corp. v. North Dakota*, 112 S. Ct. 1904 (1992). That case involved a State's ability under the Constitution to require an out-of-state mail order vendor with no physical presence in the taxing State to collect the State's use tax on sales to its residents. In its prior decision in *National Bellas Hess, Inc. v. Department of Revenue*, 386 U.S. 753 (1967), involving that identical question, the Court held that a State cannot impose such an obligation on a seller "whose only connection with customers in the [taxing] State is by common carrier or the United States mail." 386 U.S. at 758. The Court in *Quill* rejected North

[1] All citations herein to Appendices to the Petition for a Writ of Certiorari are referred to by "Pet. App." followed by the letter designation of the Appendix and a page reference.

Dakota's argument that the bright-line physical presence test enunciated in *Bellas Hess* was no longer part of the Commerce Clause "substantial nexus" requirement. In that context, however, the Court stated,

> "Although we have not, in our review of other types of taxes, articulated the same physical-presence requirement that *Bellas Hess* established for sales and use taxes, that silence does not imply repudiation of the *Bellas Hess* rule."

112 S. Ct. at 1914.

The South Carolina court mischaracterized the foregoing statement as a rejection of the physical presence requirement in the context of taxes other than use taxes. In footnote 4 the South Carolina court stated:

> "The U.S. Supreme Court recently revisited the physical presence requirement of *Bellas Hess* and, while reaffirming its vitality as to sales and use taxes, noted that the physical presence requirement had not been extended to other types of taxes."

Pet. App. A at 9a.

The Court has not articulated the physical presence requirement in the context of other types of taxes simply because the issue has not been presented since 1977 when the Court in *Complete Auto Transit, Inc. v. Brady*, 430 U.S. 274 (1977), formulated the currently applicable tests for sustaining a tax against Commerce Clause challenge. To conclude from that vacuum that the physical presence requirement "ha[s] not been extended to other types of taxes" is simply wrong; worse, to conclude that the physical presence requirement has no application beyond use taxes is to compound the error.

If anything is "well settled," it is that a taxpayer must have a tangible, physical presence in a State for its income to be taxable there. In *Quill* the Court pointed

out that all of the cases cited by the North Dakota court to support its conclusion that recent cases of the Court had "signalled a 'retreat from the formalistic constrictions of a stringent physical presence test . . . .'" (quoting from *State v. Quill Corp.*, 470 N.W.2d 203, 214 (N.D. 1991)), "involved taxpayers who had a physical presence in the taxing State and therefore do not directly conflict with the rule of *Bellas Hess* . . . ." *Quill*, 112 S. Ct. at 1914. It is thus not surprising that the South Carolina court could not cite a single case supporting its contrary proposition. Based squarely on *Bellas Hess* and reaffirmed last term by *Quill*, physical presence has commonly been thought by both taxpayers and taxing authorities to be the touchstone of jurisdiction to tax under the Commerce Clause. As such, physical presence is a line that, in the context of income taxes, is only slightly less bright than it is in the context of use taxes. The absence of any decisions of the Court on the point in the income tax context attests to the widespread consensus among taxpayers and the States that physical presence is necessary to satisfy the "substantial nexus" requirement of the *Complete Auto* test. Indeed, if that were not so, Quill would be subject to income tax in North Dakota even though not required to perform the administrative duty of collecting that State's use tax. Such a result would make no sense at all.

South Carolina itself evidently thought that physical presence was required at the outset of this case. The South Carolina Tax Commission (the "Commission") initially proposed income tax deficiencies against Toys "R" Us, the entity licensed to use Petitioner's trademarks, based on the disallowance of the deductions claimed for trademark royalties paid to Petitioner. Only after Toys "R" Us protested that assessment did the

Commission assert, and then only as an alternative argument, that the Petitioner itself was subject to South Carolina income tax on those royalties.

The error by the South Carolina court stems from its failure to recognize that the trial court based its decision on a clearly erroneous view of the substantial nexus requirement. The trial court decision rests squarely on the premise that the nexus requirement is the same for both Due Process and Commerce Clause purposes. The trial court characterized that requirement as some "minimal connection"—"whether the state has provided some protection, opportunity, or benefit for which it can ask a return [citing *Wisconsin v. J.C. Penney Co.*, 311 U.S. 435 (1940).]." We now know from *Quill* that the Due Process and Commerce Clause nexus requirements are not the same and that the minimal connection language characterizes the Due Process test, not the Commerce Clause test. *Quill* teaches that,

> "while a State may, consistent with the Due Process Clause, have the authority to tax a particular taxpayer, imposition of the tax may nonetheless violate the Commerce Clause."

112 S. Ct. at 1909.

The Supreme Court of South Carolina (unlike the trial court) had the benefit of *Quill*, but it seemed completely oblivious to the distinction drawn there between Due Process nexus and Commerce Clause nexus. While *Quill* makes clear, in the context of the use tax collection duty, that "the requirements of due process are met irrespective of a corporation's lack of physical presence in the taxing State," 112 S. Ct. at 1911, *Quill* emphatically rejected extending that holding to the Commerce Clause "substantial nexus" requirement. Yet that is precisely what the Supreme

Court of South Carolina has summarily done here. If allowed to stand, the decision in this case will quickly become the opening shot in the States' efforts to extend their taxing jurisdiction to entities whose contact with and presence in the State is no more substantial than in the present case. In crossing what has heretofore been a line no less clear, though less explicitly articulated, than the one drawn in *Bellas Hess* (and only recently reaffirmed in *Quill*), the consequence will be to subject a significant segment of interstate commerce to far greater compliance and liability burdens than ever thought possible up to now. As the Court pointed out in *Quill*, there are more than 6000 taxing jurisdictions in this country. Given the revenue pressures to which those jurisdictions typically are subject, it is unrealistic not to expect that all of them will quickly seek to exploit the taxing monster created by the South Carolina court's decision.

It is not only the ongoing burden on interstate commerce that is implicated in this case. Precisely because physical presence has been regarded by both taxpayers and taxing jurisdictions as a requirement of the Commerce Clause, few taxpayers without physical presence in a State have ever filed income tax returns in that State. That leaves them open to substantial unanticipated liabilities for back income taxes, interest, and penalties. Moreover, there is no limit to that liability since rarely, if ever, does a State's statute of limitations begin to run absent the filing of a return.

While the Court has made it clear that interstate commerce "may be made to pay its own way," *Complete Auto*, 430 U.S. at 289 n.15, limits remain. The Commerce Clause exists as a "means for limiting state burdens on interstate commerce." *Quill*, 112 S. Ct. at 1913. Until

now, physical presence has served as the bright line that divides the burdensome, prohibited income tax from the permitted income tax. The settled expectations of taxpayers in that regard are best left for Congress and the political process to undo, particularly given the retroactive liabilities implicated by the sweeping principle enunciated by the South Carolina court. If entities like Petitioner are to be required to pay income taxes to States in which their contacts and presence are as thin as they are here, it is Congress that should make that decision, with such safe harbors and limitations as may be determined after appropriate opportunity for hearings to consider the economic implications of such a course. For example, see Public Law 86-272, 73 Stat. 555 (1959), 15 U.S.C. §381 *et seq.*, recently construed by the Court in *Wisconsin Department of Revenue v. William Wrigley, Jr., Co.*, 112 S. Ct. 2447 (1992).

2. The Physical Presence Requirement is Not Satisfied by Petitioner's Intangible Property.

While the South Carolina court summarily rejected in one sentence Petitioner's reliance on the physical presence test, the court also held that Petitioner satisfied that test, based on "licensing intangibles for use in this State and deriving income from their use here." Pet. App. A at 10a. The only direct authority for that proposition cited by the South Carolina court was *American Dairy Queen Corp. v. Taxation and Revenue Dept.*, 93 N.M. 743, 605 P.2d 251 (1979). That decision by an intermediate appellate court did not analyze the Commerce Clause nexus issue, but merely concluded that the issue had already been decided adversely to the taxpayer in two prior decisions of the same New Mexico Court of Appeals involving similar but different taxpayers: *Baskin-Robbins Ice Cream Co. v. Revenue*

Div., 93 N.M. 301, 599 P.2d 1098 (1979), and *Aamco Transmissions v. Tax. & Rev. Dept.*, 93 N.M. 389, 600 P.2d 841 (1979). However, neither of those cases involved the Commerce Clause issue present here. In *Baskins-Robbins*, the Court of Appeals concluded that the license agreement involved was "completely performed in New Mexico by [the licensee], so that the performance of the contract is not within the protection of the Commerce Clause." 599 P.2d at 1101. Only intrastate commerce was involved. "The Commerce Clause plays no part in the instant case." 599 P.2d at 1102. Far from interpreting the Commerce Clause substantial nexus requirement, *Baskins-Robbins* disavowed any Commerce Clause aspects to the case.

Aamco Transmissions reached the same conclusion. In addition, the licensor was found to be leasing tangible property (its signs) in New Mexico. A case subjecting a taxpayer that has a physical presence in New Mexico to tax provides no support for subjecting an entity that has no physical presence to tax.

At bottom, the New Mexico cases cited by the South Carolina court simply are not authority for the proposition that intangible property alone can establish substantial nexus for Commerce Clause purposes. In any event, any implication drawn from those cases that licensing intangible property in the State provides the required "substantial nexus" is completely undercut by the Court's decision in *Quill*. Noting that Quill also licensed software to some of its North Dakota clients, the Court agreed that "the existence of a few floppy diskettes to which Quill holds title seems a slender thread upon which to base nexus" [quoting from the State's brief].

> "We therefore conclude that Quill's licensing of software in this case does not meet the 'substantial nexus' requirement of the Commerce Clause."

112 S. Ct. at 1914 n.8.

If Quill's purposeful licensing of software directly to customers residing in North Dakota does not meet the substantial nexus requirement, Petitioner's licensing of trademarks to Toys "R" Us that Toys "R" Us later determines (without the involvement of Petitioner) to use in South Carolina even more clearly fails that requirement.

The South Carolina court also referred to this Court's decision in *International Harvester Co. v. Wisconsin Department of Taxation*, 322 U.S. 435 (1944), as indirect support for its conclusion that the presence of intangible property alone (rather than physical property) is sufficient to establish nexus. However, only the Due Process Clause was at issue in *International Harvester*; the Commerce Clause was not involved. Since that case dealt with "whether the taxing power exerted by the state bears fiscal relation to protection, opportunities, and benefits given by the state," (quoting *Wisconsin v. J.C. Penney Co., supra*, at 441-442 (1940)) for purposes of the Due Process Clause, the decision no longer has any relevance to whether Petitioner has substantial nexus with South Carolina for Commerce Clause purposes.

The South Carolina decision is nothing less than the adoption for Commerce Clause substantial nexus purposes of the exploitation of the market theory urged by North Dakota in its case against Quill. This Court in *Quill* rejected that theory. Adoption of such a broad sweeping nexus standard and departure from the physical presence requirement, if it is to be done, should be left to Congress and the political process. As the

Court pointed out in *Quill*, the substantial nexus requirement (as well as, to a lesser extent, the "fairly related to the services provided by the taxing state" prong of the *Complete Auto* test) is "a means for limiting state [tax] burdens on interstate commerce." It would be hard to imagine any more burdensome requirements on interstate commerce than will attend the activities of entities like Petitioner if the South Carolina decision is allowed to stand.

One need look no further than the example of the recently retired superstar of the Chicago Bulls, Michael Jordan. The newspapers have well documented the huge cash cow that the business of licensing the man's name and likeness have become. It is fair to say that, under the South Carolina court's decision, all of the nation's 6000 plus taxing jurisdictions can claim the right to tax a piece of that cow, based on nothing more than the purchase of goods bearing the Jordan likeness and name by customers in the jurisdiction. The compliance cost burden in that event is self evident. It would be a startling development indeed if the Commerce Clause no longer stands as a barrier to the imposition of such burdens on commercial enterprise.

Only as part of a legislative process can an appropriate balance be struck between the revenue interests of the 6,000 various taxing jurisdictions throughout the country and the difficulty that many of the participants in the interstate commerce in intangible property will encounter in shouldering the enormous burden of complying with the multiple requirements of those jurisdictions. The Court in *Quill* noted that many of these burdens might now be bearable in light of the technological advances in computers that have occurred since its earlier decision in *Bellas Hess*. However, while that may be generally true with respect to some large

enterprises that purposefully and systematically market tangible property in the various States, the same cannot be said as broadly and with the same level of confidence about those who sell intangible property in interstate commerce. Consider, for example, the inventor who licenses a patent or other technology to a licensee that, without any further involvement from the licensor, applies the technology throughout the country. Likewise, consider the artist who licenses his or her copyright but does not control where the artistic work will be performed. The same example could be framed in the context of other owners of intellectual or other intangible property who commercially license their property but, as is often the case in such transactions, do not control how or where it is used.

For such persons engaged in the interstate commerce in ideas and similar intellectual property, the broad test of nexus advanced by the South Carolina court could be severely debilitating by requiring them to account for their income to an untold number of independent taxing jurisdictions with widely differing reporting requirements. Unlike the large mail-order enterprises considered in *Quill*, many of these entrepreneurs will find it burdensome, and often economically impractical, to access the necessary computer technology to comply with the laws of the myriad taxing jurisdictions to which the South Carolina nexus rule will expose them.

The bright-line physical presence test has served to prevent such consequences. If that test is to be abandoned, it should be replaced with a test that can accommodate the competing considerations in a way that will minimize the negative impact on this important commerce in intangible property. That, however, is most effectively accomplished through legislation because the

judicial process is simply not as well-suited as is the legislative process to effect such delicate accommodations. In particular, it would be more appropriate that a legislative judgment, rather than a judicial pronouncement, be the basis for a determination, such as that urged by South Carolina, that one test for nexus applies with respect to one type of tax and an entirely different test applies with respect to another type of tax. In the absence of such legislation, OCC urges the Court not to abandon the bright-line physical presence test of Commerce Clause nexus.

Because of this substantial impact on the increasingly important interstate market in intellectual property and similar intangibles, the Commerce Clause issue in this case plainly warrants the Court's review.

3. The South Carolina Court Has Misinterpreted the Due Process Minimum Connection Requirement.

The state court seriously erred in concluding that Petitioner's contacts with South Carolina satisfy the "minimum connection" requirement of the Due Process Clause. The court's conclusion was based on the twin premises that Petitioner purposely directed its activities toward South Carolina and that Petitioner had intangible property in the State. Neither premise can stand. Petitioner itself did nothing purposefully directed toward South Carolina. It merely licensed its trademarks to Toys "R" Us at a time, it should be noted, when South Carolina was not even in the picture. The South Carolina court either confused the activities of Toys "R" Us in South Carolina, which clearly satisfy the minimum connection requirements as to Toys "R" Us, with the activities of Petitioner, none of which were purposely directed toward South Carolina, or it was attributing the activities of Toys "R" Us to Petitioner. There is simply

no basis for either conclusion. Toys "R" Us was not the agent of Petitioner in soliciting sales, or licenses of trademarks in South Carolina. Its activities in the State were solely for its own benefit. While those activities of Toys "R" Us necessarily employed Petitioner's trademarks that it was licensed to use, there was nothing intentional or purposeful in that respect that could be attributed to Petitioner.

Indeed, the South Carolina court did not determine otherwise. Rather, the sole basis for saying that Petitioner "purposefully directed its activities toward South Carolina" is that it did not prohibit Toys "R" Us from using the licensed trademark in that State. The OCC respectfully submits that placing such a spin on the "purposefully directed" characterization is a quantum leap from the direct and purposeful activities of the taxpayer that were held to satisfy the minimum connection requirement in *Quill*. The South Carolina court's test fundamentally destroys the substance of the minimum connection standard. Any entity that licenses another to use a trademark or other intangible property will be subject to tax in every jurisdiction in which the licensee uses such intangible property. The activities of the licensee, not the licensor, will become the touchstone of tax liability. The OCC submits that such an unexpected expansion of the Due Process nexus requirements offends "traditional notions of fair play and substantial justice." *International Shoe Co. v. Washington*, 326 U.S. 310, 316 (1945).

The South Carolina court's second premise, that the "minimum connection" required by due process was satisfied by the presence in the State of Petitioner's intangible property, is equally flawed. The court concluded that sales in South Carolina by Toys "R" Us created accounts receivable in favor of Petitioner,

presumably because the trademark royalties payable are based on a percentage of sales by Toys "R" Us. But the court leaps from that fact to the conclusion that the accounts receivable are South Carolina property. Even if it is conceded that South Carolina sales of Toys "R" Us create accounts receivable, it does not follow that South Carolina is the situs of those receivables. Toys "R" Us, not its South Carolina customers, is the debtor. The court cites no authority for its extraordinary conclusion that Petitioner's accounts receivable from Toys "R" Us have a South Carolina situs, but merely assumes that to be the case. That result makes a mockery of the "minimum connection" standard. That test would be satisfied in every jurisdiction in which Toys "R" Us made a sale that gives rise to an obligation to pay a royalty to Petitioner. Indeed, it will lead to the absurd conclusion that two otherwise identically situated taxpayers will be treated differently for purposes of the Due Process nexus requirement based solely on whether the sale is a cash transaction or a credit transaction. That is a breathtaking expansion of the "minimum connection" concept. The result will be dramatically different obligations imposed on licensors such as Petitioner than were heretofore thought possible. Such a giant step warrants this Court's careful review.

4. The Relationship Between Petitioner and Toys "R" Us Does Not Justify Lowering Commerce Clause or Due Process Nexus Standards.

Although the South Carolina court does not explicitly discuss the point, one cannot read the decision without sensing a strain on the part of the court to prevent what it may have perceived was the tax avoidance otherwise achieved by the arrangement between Petitioner and Toys "R" Us. It is conceded that

the use of a Delaware holding company to license trademarks reduces the state tax burden of the Toys "R" Us group of which Petitioner is a part—or at least it did until this case. That consequence is a well understood attribute of the use of Delaware holding companies. On the one hand, there is no justification for treating the Petitioner as other than a separate corporate entity from Toys "R" Us, particularly in the absence of any evidence that the Petitioner is a sham or lacks economic substance—a determination that the South Carolina courts have not made. In the federal income tax context, this Court has long held that such substantial corporations must be recognized as entities separate and distinct from their shareholders. *See, e.g., Moline Properties, Inc. v. Commissioner,* 319 U.S. 436 (1943), and *National Carbide Corp. v. Commissioner,* 336 U.S. 422 (1949). In that light, it is appropriate to apply to the Petitioner the same principles that would be extended to an unrelated owner and licensor of the trademarks. That, of course, is what makes the decision of the South Carolina court so extraordinary.

On the other hand, the OCC is not an apologist for Delaware holding companies or the tax savings they purport to achieve. There are ways of dealing with any perceived injustices that the use of such companies by related entities may produce, such as using the unitary method, requiring combined reporting, or disallowing deductions for amounts such as royalties paid to Delaware holding companies. Indeed, South Carolina initially utilized the latter approach in this case, but for its own reasons elected not to pursue that approach. The point is that the existing constitutional nexus standards should not, and need not, be eviscerated merely to remedy perceived abuses arising from the use of Delaware holding companies by related parties, especially when the

States have readily acknowledged tools for addressing any such concerns. That, *sub silentio*, is what the South Carolina court has done here. While this case involves use of a Delaware holding company by related entities, the constitutional principles at issue are not limited to that situation, but apply as well to unrelated entities that are not part of a holding company structure. The implications of this case in the context of related taxpayers are nothing short of extraordinary. The implications in the context of unrelated taxpayers are staggering.

CONCLUSION

This case is another battle in the unceasing war between the States and taxpayers over who is subject to tax. The South Carolina court has declared victory for the State by brushing aside existing notions of the standards governing nexus for Commerce Clause and Due Process purposes. The court seems not to have appreciated the factual distinctions that make this case unusual and the result so astonishing. If the judgment is not reversed, and the governing principles clarified, entities, like Petitioner, operating in interstate commerce will assuredly find themselves subject to greatly expanded ongoing liability and reporting requirements in thousands of jurisdictions—to say nothing of the liabilities for taxes their past activities might have engendered. The issues posed in this case are of far-reaching concern to a substantial portion of the business community. The South Carolina court resolved these issues in a fashion that the OCC believes is not only fundamentally wrong, but will also do serious harm to interstate commerce if not reversed.

Accordingly, OCC respectfully urges that the petition for a writ of certiorari to the Supreme Court of South Carolina be granted.

Respectfully submitted,

TERRENCE G. PERRIS
Counsel of Record
WILLIAM H. CONNER
SQUIRE, SANDERS & DEMPSEY
4900 Society Center
127 Public Square
Cleveland, Ohio 44114
(216) 479-8647

TED B. CLEVENGER
SQUIRE, SANDERS & DEMPSEY
1300 Huntington Center
41 South High Street
Columbus, Ohio 43215
(614) 365-2700

Counsel for Amicus Curiae
Ohio Chamber of Commerce

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